Fiduciary Duties in Business Entities

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I. INTRODUCTION

The sixteen years from 1990 through 2005 were a time of major activity in the Kansas law of business organizations. This Article has its genesis in the confluence of several trends that emerged during that period. First, on the legislative front, Kansas both enacted and subsequently totally revised statutes recognizing two new forms of business entities, limited liability companies1 and limited liability partnerships;2 adopted a completely revised general partnership act;3 and significantly updated its corporation code.4 Second, because Kansas has consciously chosen to follow Delaware's lead in business legislation, Kansas courts began to articulate explicitly the persuasive effect of Delaware precedent in Kansas.5 Finally, there has been a discernable convergence in much of the law governing fiduciaries in business entities. Certainly, this trend is due in part to the invention of the limited liability company, which is a hybrid that can exhibit characteristics of both partnerships and corporations and that has no history of its own upon which to draw. More broadly, however, it seems clear that

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5. E.g., Burcham v. Unison Bancorp, Inc., 276 Kan. 393, 412, 77 P.3d 130, 144–45 (2003) (observing that Kansas corporation law was patterned after Delaware law and adopting a rule of the Delaware Supreme Court); Achey v. Linn County Bank, 261 Kan. 669, 676, 931 P.2d 16, 21 (1997) (stating that “decisions of the Delaware courts involving corporation law are persuasive” in interpreting Kansas corporation law.). Because this practice has become commonplace, this Article will rely heavily on Delaware case law.
managers of businesses are fiduciaries regardless of the technical form in which the enterprise is organized and that the real-life problems attendant on such managerial status often resist pigeonholing on the basis of entity form. Consequently, the borrowing of workable concepts, and even specific precedent, from other forms of enterprise appears to be an increasingly common practice.

The modest goal of this Article is to survey generally the law of fiduciary and related duties with respect to Kansas corporations, partnerships (general, limited, and limited liability) and limited liability companies, and to illustrate the extent to which corporate law concepts and precedents are being applied in the context of these other forms of organization. Part II considers fiduciary status, Part III the duty of care, Part IV the duty of good faith, and Part V the duty of loyalty.

II. FIDUCIARY STATUS

A fiduciary relationship is one in which a person transacts business or manages money or property, not primarily for the person's own benefit, but for the benefit of another. It involves discretionary authority on the part of the fiduciary and dependency and reliance on the part of the beneficiary.

A. Corporations

In Kansas and elsewhere, the bedrock statutory corporate norm is that the business and affairs of a corporation are managed by or under the direction of its board of directors. In pursuit of this function, the board elects officers who are agents of the corporate entity and who exercise


7. For example, in a parallel to corporate law, the statutes governing limited liability companies and limited partnerships both provide for the possibility of derivative litigation instituted by a minority member or partner to redress a breach of duty to the enterprise. KAN. STAT. ANN. §§ 17-76,130 to -76,133 (Supp. 2005); §§ 56-1a551 to -1a554 (2005).


10. KAN. STAT. ANN. § 17-6301(a) (Supp. 2005).

11. KAN. STAT. ANN. § 17-6302(a), (b) (Supp. 2005).
the managerial authority formally and informally delegated to them by the board. Because they manage the business for the benefit of the shareholders, corporate directors and officers have long been recognized to occupy a fiduciary relationship to both the corporation and its shareholders. 13

Shareholders, on the other hand, traditionally have not been regarded as fiduciaries. 14 This result is justified on the basis that, when acting as a shareholder, a person acts as an owner rather than in a representative, managerial capacity. Controlling shareholders, however, have come to stand on a different footing.

Because directors and officers manage the business, nearly all situations that spawn breach of fiduciary duty allegations involve director or officer conduct. If a controlling shareholder is an individual, the shareholder usually will also be a director and officer and will be subject to fiduciary duties in those capacities. 15 If a controlling shareholder is another business entity, it cannot personally be a director or officer, but it typically will place its own officers, agents, and employees in those positions. 16 If the controlling shareholder dominates and controls those individuals when they act in a managerial capacity as corporate directors and officers, the controlling shareholder will be subject to vicarious fiduciary responsibility as a matter of basic agency law. 17

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12. Although technically, neither the board of directors nor an individual director is, as such, an agent of the corporation, corporate officers are agents. RESTATEMENT (SECOND) OF AGENCY § 14C & cmts. (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01, cmt. f(2) (Tentative Draft No. 2, 2001). Agency, by definition, is a fiduciary relationship. RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01 (Tentative Draft No. 2, 2001).


15. Cf. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.23(a)(4) (1994) (stating that a shareholder is "interested" in a transaction or conduct if the shareholder is a party or if the shareholder is also interested in the shareholder's capacity as a director or officer).

16. Occasionally, this will also be true of a controlling shareholder who is an individual.

17. RESTATEMENT (SECOND) OF AGENCY §§ 1, 2, 212, 219 (1958); RESTATEMENT (THIRD) OF AGENCY §§ 1.01, 2.04, 7.04, 7.07 (Tentative Drafts Nos. 2 & 5, 2001 & 2004).
This theory of fiduciary responsibility, and the distinction between acting as an owner and acting in a representative, managerial capacity, are both clearly articulated in the classic case of *Zahn v. Transamerica Corp.* The court emphasized that

there is a radical difference when a stockholder is voting strictly as a stockholder and when voting as a director; that when voting as a stockholder he may have the legal right to vote with a view of his own benefits and to represent himself only; but that when he votes as a director he represents all the stockholders in the capacity of a trustee for them and cannot use his office as a director for his personal benefit at the expense of the stockholders.

On the facts alleged, the operative conduct (redemption of the minority's shares at a grossly inadequate price) occurred at the director level. However, Transamerica, the controlling shareholder, so dominated and controlled the directors that the court characterized the relationship as one of agency. Thus, the court concluded that the liability flowing from the directors' dereliction was rightly imposed on Transamerica, which, because of its control, legally constituted the board of directors of the corporation.

The Delaware Supreme Court took this same approach, albeit in abbreviated form, in *Sinclair Oil Corp. v. Levien.* Sinclair owned ninety-seven percent of the stock of Sinven, one of Sinclair's several subsidiaries. The Chancellor had found as a fact that Sinven's directors were not independent of Sinclair, but rather were directors, officers and employees of corporations in the Sinclair complex. The court therefore held that "[b]y reason of Sinclair's domination" of the Sinven board, Sinclair owed Sinven a fiduciary duty.

Because of the reality that the kind of domination and control found in *Zahn* and *Sinclair* will almost invariably exist in the context of parent and subsidiary corporations, the analysis became even more abbreviated and rarefied in the 1990s. Section 1.10 of the *Principles of Corporate Governance* defines a "controlling shareholder" as a person who either:

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18. 162 F.2d 36 (3d Cir. 1947).
19. *Id. at* 45.
20. *Id. at* 39-40, 45-46.
21. *Id. at* 40, 46.
22. *Id. at* 46.
23. 280 A.2d 717 (Del. 1971).
24. *Id. at* 719.
25. *Id. at* 719.
26. *Id. at* 719.
(1) owns and has the power to vote a majority of the outstanding voting stock; or (2) otherwise exercises a controlling influence over the management or policies of the corporation or the transaction or conduct in question by reason of the person’s position as a shareholder. Four points are apparent from this bifurcated definition. First, if the person is a majority shareholder, the person is conclusively deemed to be a controlling shareholder subject to fiduciary obligations. Second, if the person owns less than an absolute majority of the voting stock, controlling shareholder status is a question of fact. Third, the question of fact is whether, notwithstanding ownership of less than a majority block, the person “otherwise” exercises a controlling influence over the corporation’s “management or policies.” Thus, the basis of both parts of the definition continues to be traditional fiduciary principles: whether the person has power to act, directly or indirectly by means of agents, in a discretionary, managerial capacity with respect to the property of others. The only difference is that in one case controlling influence is conclusively presumed and in the other it must be established as a fact.

Delaware case law has also evolved to a similar majority-versus-less-than-majority distinction in its analysis of controlling shareholder fiduciary duties. For example, the court in Kahn v. Lynch Communication Systems held that a shareholder became a fiduciary only if the shareholder owned a majority interest or exercised control over the corporation’s business affairs. The focus continues to be on a dominating relationship over corporate conduct and affairs, either by means of majority stock ownership or proof of actual domination and control of the board of directors.

27. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 15, § 1.10(a).
28. Id. Section 1.10(b) assists a plaintiff in the latter instance by raising a rebuttable presumption of control over management or policies if the person owns or controls more than twenty-five percent of the voting stock.
29. 638 A.2d 1110 (Del. 1994).
30. Id. at 1113.
31. See id. at 1114. The Kahn court stated, Alcatel held a 43.3 percent minority share of stock in Lynch. Therefore, the threshold question . . . was whether, despite its minority ownership, Alcatel exercised control over Lynch’s business affairs. Based upon the testimony and the minutes of the . . . Lynch board meeting, the Court of Chancery concluded that Alcatel did exercise control over Lynch’s business decisions.
32. But see Williams v. Geier, 671 A.2d 1368, 1378 & n.22 (Del. 1996) (indicating that domination and control must be alleged and proven even in cases of majority ownership). Without much regard for the niceties, Kansas courts have not hesitated to impose fiduciary duties on controlling shareholders where circumstances have warranted. E.g., Richards v. Bryan, 19 Kan. App. 2d 950, 879 P.2d 638 (1994) (in holding for oppressed minority shareholder of subsidiary corporation, court failed to differentiate between acts of parent corporation and acts of its shareholders, who were also directors of subsidiary).
On the other hand, if no director or officer conduct is involved—that is, if the controlling shareholder is simply acting strictly as a shareholder—respondeat superior is inapplicable because there is no breach by the inferior. In these situations, the general rule has been, and continues to be, that the controlling shareholder is not subject to fiduciary responsibilities. As stated by the Tenth Circuit Court of Appeals: "In other words, a dominant or majority stockholder does not become a fiduciary for other shareholders by reason of mere ownership of stock. It is only when one steps out of the role as a stockholder and acts in the corporate management... that he assumes the burden of fiduciary responsibility."\(^{32}\)

B. Partnerships

Partners in general partnerships and limited liability partnerships are in a fiduciary relationship to the partnership and to other partners.\(^{33}\) The reason is that each partner is an agent of the partnership and, unless otherwise agreed, each has an equal right to participate in the management and conduct of its business.\(^{34}\) As such, each partner possesses the kind of discretionary managerial authority that is the hallmark of fiduciary status in a business setting.

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32. McDaniel v. Painter, 418 F.2d 545, 547 (10th Cir. 1969) (applying Kansas law). The rule that, with certain narrow exceptions, a controlling shareholder is free to transfer the controlling block of shares at a premium without having to share the offer or the premium with the minority is perhaps the best example of this proposition. See id. (noting that a controlling block of shares should command a premium because it is more valuable than minority stock); Richie v. McGrath, 1 Kan. App. 2d 481, 571 P.2d 17 (1977) (finding no breach of fiduciary duty, even though sale occurred in secret); PRINCIPLES OF CORPORATE GOVERNANCE, supra note 15, § 5.16.

33. KAN. STAT. ANN. § 56a-404(a) (2005); REVISED UNIF. P'SHIP ACT § 404 cmt. 1 (1997) ("[T]he law of partnership reflects the broader law of principal and agent, under which every agent is a fiduciary.").

34. KAN. STAT. ANN. §§ 56a-301, -401(f) (2005). Limited liability partnerships must be distinguished from limited partnerships. Limited liability partnerships are an innovation of the 1990s, and except with respect to the personal liability of the partners, a limited liability partnership is, in most respects, identical to a general partnership. It is formed under and governed by the same statute as a general partnership, and its partners play the same role in managing its business and affairs. See KAN. STAT. ANN. § 56a-101(e) (2005) (defining the term "limited liability partnership"); KAN. STAT. ANN. § 56a-306(a) (2005) (establishing the general rule that partners are jointly and severally liable for partnership obligations); KAN. STAT. ANN. § 56a-306(c) (establishing the rule that joint and several liability does not apply to limited liability partnerships); KAN. STAT. ANN. § 56a-1001 to -1004 (2005) (addressing specific aspects of limited liability partnerships). Limited partnerships are a completely different form of business organization. They have a much longer history, they are governed by a separate statute, and, by definition, they have two kinds of partners who typically play very different roles in the partnership. See KAN. STAT. ANN. § 56-1a101(e)–(g) (2005) (defining "general partner," "limited partner," and "limited partnership"); KAN. STAT. ANN. § 56-1a203 (2005) (limiting the liability of limited partners); KAN. STAT. ANN. § 56-1a253 (2005) (establishing rights and obligations of general partners).
Limited partnerships, by definition, have two kinds of partners: general and limited.\textsuperscript{35} Unless otherwise agreed, general partners have the same rights and powers, and they are subject to the same restrictions and liabilities, as partners in a general partnership.\textsuperscript{36} Therefore, the general partners are agents of the limited partnership, control management of its business, and are subject to the same fiduciary duties as partners in a general partnership.\textsuperscript{37} Conversely, limited partners typically are passive investors who do not participate in management, and who, for that reason, are not in a fiduciary relationship with the limited partnership or the other partners.\textsuperscript{38}

\textbf{C. Limited Liability Companies}

In Kansas and elsewhere, limited liability companies have two management paradigms. The statutory default rule provides for decentralized, partnership-like management by the members, with each member being an agent of the limited liability company and having voting rights in proportion to the member’s interest in profits.\textsuperscript{39} For this reason, the members occupy a fiduciary relationship to the limited liability company and to each other similar to that of partners in a general partnership.\textsuperscript{40}

A limited liability company’s operating agreement, however, may provide for centralized management by vesting managerial authority in one or more managers.\textsuperscript{41} In such a case, the managers, whether or not they are also members, would be agents of the limited liability company and subject to fiduciary duties akin to those of corporate directors and

\begin{thebibliography}{9}
\bibitem{35} § 56-1a101(e)-(g).
\bibitem{36} § 56-1a253.
\bibitem{38} KAN. STAT. ANN. §§ 56-1a202(a) (2005) (providing that limited partners’ special rights may be set forth in a partnership agreement), § 56-1a202(b) (permitting limited partners to be granted voting rights by a partnership agreement), § 56-1a203(a) (establishing the general rule of no liability for limited partners); \textit{In re} Villa West Assocs., 193 B.R. 587, 593 (D. Kan. 1996) (comparing limited partners’ passive status to that of corporate shareholders).
\bibitem{39} KAN. STAT. ANN. § 17-7693(a) (Supp. 2005).
\bibitem{40} \textit{See} Maillot v. Frontpoint Partners, L.L.C., No. 02 Civ. 7865(GBD), 2003 WL 21355218, at *3 (S.D.N.Y. June 10, 2003) (denying, under Delaware law, defendant’s motion for summary judgment that posited members in a limited liability company do not owe a fiduciary duty); Cimarron Feeders v. Bolle, 28 Kan. App. 2d 439, 448, 17 P.3d 957, 964 (2001) (finding the trial court appropriately compared rules governing partnership duty to that of limited liability companies).
\bibitem{41} § 17-7693(a).
\end{thebibliography}
officers.\textsuperscript{42} The nonmanaging members, whose positions would be analogous to that of shareholders or limited partners, generally would not be subject to fiduciary obligations.\textsuperscript{43} However, to the extent that a majority or controlling member exercised a dominating influence over the managers, such member would be subject to vicarious fiduciary duties on the same basis as a majority or controlling shareholder.\textsuperscript{44}

III. DUTY OF CARE

A. Corporations

It is generally recognized that there are two functionally different aspects to directors’ managerial roles. The \textit{Corporate Director’s Guidebook} explains them as follows:

Directors’ activities in providing leadership... can be described as comprising two basic functions: decision-making and oversight. The decision-making function generally involves formulating corporate policy and strategic goals with management, and taking actions with respect to specific matters.... The oversight function concerns ongoing monitoring of the corporation’s business and affairs and, in particular, attention to corporate business performance, plans and strategies, risk assessment and management, compliance with legal obligations and corporate policies, and the quality of financial and other reports to shareholders, as well as attention to matters suggesting a need for inquiry or investigation.\textsuperscript{45}


\textsuperscript{43} Cf. § 17-7693(b)(1) (providing that in a manager-managed limited liability company, no member acting solely in the capacity of member is an agent of the limited liability company). The \textit{Uniform Limited Liability Company Act} § 409(h)(1), 6A U.L.A. 601 (1996), which has not been enacted in Kansas, addresses the point specifically, and provides that “a member who is not a manager owes no duties to the limited liability company or to other members solely by reason of being a member.”


\textsuperscript{45} \textit{Committee on Corporate Laws, ABA Section of Business Law, Corporate Director’s Guidebook} 5 (4th ed. 2004) [hereinafter \textit{Corporate Director’s Guidebook}].
Correspondingly, there are two distinctly different bases on which a plaintiff might allege a breach of duty of care. As stated by the Delaware Court of Chancery in *In re Caremark International Inc. Derivative Litigation*:

Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.\(^46\)

Accordingly, because the policies and method of analysis differ somewhat, the following discussion considers these two contexts separately. The *Caremark* court noted that "[t]he first class of cases will typically be subject to review under the director-protective business judgment rule."\(^47\)


If directors have made an honest, informed, and unselfish business decision, most courts are reluctant to second-guess the decision simply because it turns out badly. This judicial deference is known as the business judgment rule, and, when applicable, it protects directors' decisions that fall short of being grossly negligent, reckless, or irrational.\(^48\) To qualify for business judgment rule protection, the following conditions must be satisfied: (1) good faith; (2) a conscious decision to act or not act; (3) an adequate informational basis for the

\(^{46}\) 698 A.2d 959, 967 (Del. Ch. 1996) (emphasis omitted).

\(^{47}\) Id.

\(^{48}\) E.g., Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984); PRINCIPLES OF CORPORATE GOVERNANCE, supra note 15, § 4.01(c) & cmt.

f. The point was articulated by the court in *Joy v. North* as follows:

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.

692 F.2d 880, 885 (2d Cir. 1982) (citations omitted).
decision; and (4) the absence of a conflict of interest.\textsuperscript{49} In Delaware, the rule operates as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."\textsuperscript{50} Thus, the burden is on the party challenging the decision to rebut the presumption by demonstrating that at least one of its preconditions is lacking. If this is done, the burden shifts to the directors to show that their conduct was entirely fair.\textsuperscript{51}

As a policy matter, the business judgment rule flows from and reinforces the statutory allocation of power and functions within a corporation: shareholders elect directors, but directors, not shareholders, manage the business.\textsuperscript{52} As long as directors are acting in good faith, on an informed basis, and free from a disabling conflict of interest, they should be relatively free from having their decisions second-guessed by minority shareholders, judges, and juries acting with disavowed, but nevertheless real, hindsight. Business necessarily involves risk, and risk and potential profit are directly related. Over time, riskier decisions produce greater profit, even after factoring in losses, than do more conservative decisions. The business judgment rule recognizes this and attempts to free directors from the fear of personal liability if a decision that appeared to be a reasonable risk at the time turns out badly. A contrary rule that imposed liability on the basis of so-called simple or ordinary negligence would create an incentive for directors to pursue the least risky, most conservative of the options available to them, to the disadvantage of their shareholders generally.\textsuperscript{53}

\textsuperscript{49} E.g., \textit{Aronson}, 473 A.2d at 812–13.
\textsuperscript{50} Id. at 812.
\textsuperscript{51} E.g., \textit{Cede & Co. v. Technicolor, Inc.}, 634 A.2d 345, 361 (Del. 1993), \textit{modified}, 636 A.2d 956 (Del. 1994). In \textit{Cede}, the Delaware Supreme Court held that rebuttal of the business judgment rule shifted the burden to the directors to demonstrate the entire fairness of the transaction, even though the facts of the case did not involve self-dealing. Id. at 350, 361. This holding was unprecedented and has rightly been subjected to the criticism that it inappropriately applies the stringent duty of loyalty standard of review, along with its shifted burden of proof, to a duty of care factual situation. See Lyman Johnson, \textit{Rethinking Judicial Review of Director Care}, 24 \textit{Del. J. Corp. L.} 787, 788–801 (1999) (criticizing the \textit{Cede} court’s novel holding).
\textsuperscript{52} E.g., KAN. STAT. ANN. §§ 17-6301(a), -6501(b) (Supp. 2005); \textit{Smith}, 488 A.2d at 872; \textit{Restatement (Second) of Agency} § 14C cmt. a (1958).
With an occasional exception,\(^{54}\) Kansas courts traditionally have not used the business judgment label, but they have reached the same result by refusing to interfere with directorial discretion.\(^{55}\) Three recent decisions, however, adopt by name and apply the Delaware version of the business judgment rule, thus continuing the trend of the Kansas legislature and courts to follow Delaware’s lead in matters of business law.\(^{56}\)

Of course, as noted above, “the business judgment rule extends only as far as the reasons which justify its existence.”\(^{57}\) Thus, it is inapplicable to cases that involve uncured self-dealing,\(^{58}\) cases that involve lack of good faith,\(^{59}\) cases in which the directors have failed to inform themselves of all material information reasonably available to them before making a decision,\(^{60}\) and cases in which they have not met

54. In Cron v. Tanner the court stated:
   [P]laintiff seeks to have a court of equity substitute its business judgment for that of the directors of the bank. It is not the function of the court to manage a corporation nor substitute its own judgment for that of the officers thereof. It is only when the officers are guilty of willful abuse of their discretionary power or of bad faith, neglect of duty, perversion of the corporate purpose, or when fraud or breach of trust are involved, that the courts will interfere.

171 Kan. 57. 64, 229 P.2d 1008, 1013 (1951).


57. Joy, 692 F.2d at 886.

58. E.g., Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976); see also infra Part V.A (discussing the duty of loyalty in the corporation context).

59. E.g., In re The Walt Disney Co. Derivative Litig., 825 A.2d 275, 291 (Del. Ch. 2003); see also infra Part V.A (discussing the duty of good faith in the corporation context).

60. E.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993), modified, 636 A.2d 956 (Del. 1994); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). The Delaware standard for whether directors have sufficiently informed themselves is also one of gross negligence. Cede, 634 A.2d at 366; Van Gorkom, 488 A.2d at 873. Cf. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 15, § 4.01(c)(2) & cmt. e. (adopting an ordinary negligence standard). The court in Cede, at the very least, created a semantic anomaly by equating the duty to reach an informed decision with the “duty of care,” rather than treating it as a mere subset of the broader duty of care in the decision-making context. Cede, 634 A.2d at 366–68. Failure to recognize this extremely limited usage of “duty of care” by the Delaware courts has caused, and will continue to cause, confusion. For example, Professor Bainbridge, criticizing this aspect of Cede, states,

   Notice how the court puts the cart before the horse. Directors who violate their duty of care do not get the protections of the business judgment rule; indeed, the rule is rebutted by a showing that the directors violated their fiduciary duty of “due care.” This is exactly backwards.

their responsibilities with respect to oversight and monitoring. This latter category of cases will be discussed in the next section.

2. Monitoring and Oversight

It is a fact of life that as the size of a corporation and its business grows, direct, hands-on management by the board becomes more difficult. This practical reality is recognized explicitly by the statutory norm that provides "[t]he business and affairs of every corporation shall be managed by or under the direction of a board of directors." Thus, it is both necessary and appropriate that the board delegate, formally or informally, many of its managerial functions and responsibilities to board committees and to the corporation's senior executives. To the extent that direct decision-making authority has been so delegated, the role of the board becomes one of oversight or monitoring of the performance of the delegates in managing the business.

Depending on the size of the corporation and the complexity of its business, such oversight and monitoring may include (1) reviewing performance of the business and its operating, financial and other plans, objectives and strategies; (2) adopting codes of ethics and monitoring compliance with those codes and also with applicable laws and administrative regulations; (3) understanding the corporation's risk profile and reviewing its risk management programs; (4) understanding the corporation's financial statements and monitoring operation of its internal controls and compliance with disclosure policies and requirements; (5) choosing, setting goals for, reviewing the performance of, establishing the compensation of, and replacing when necessary the corporation's senior executives; (6) developing succession plans for the corporation's senior executives; (7) reviewing the process for providing financial and operational information to the shareholders; and (8) establishing the composition of the board and its committees and reviewing its procedures, operation and overall effectiveness.

63. See, e.g., § 17-6301(c) (allowing delegation of duties to committees); KAN. STAT. ANN. § 17-6302(a) (Supp. 2005) (allowing delegation of duties to officers); PRINCIPLES OF CORPORATE GOVERNANCE, supra note 15, §§ 3.01, 3.02(c), 4.01(b) (same).
64. CORPORATE DIRECTOR'S GUIDEBOOK, supra note 45, at 6. See also Caremark, 698 A.2d at 968-70 (discussing director liability for failure to monitor).
In performing its functions, the board is entitled to rely on the information, opinions, reports and statements of its committees, the corporate officers and employees, and outside experts, provided such reliance is in good faith and there are no circumstances that should put the directors on notice that reliance is unwarranted or that further inquiry is called for.\(^{65}\) Moreover, the board's good faith, informed, and disinterested decisions as to the specifics regarding implementation of its oversight functions are subject to the protection of the business judgment rule.\(^{66}\) Thus, breach of the directors' duty of care in this context essentially involves "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."\(^{67}\)

In such instances, the primary legal question concerns the standard of care to which directors will be held. On one hand, because an unconsidered failure to act will not be reviewed under the business judgment rule, one might logically expect liability to be predicated on simple or ordinary negligence, and that is the position taken by the American Law Institute and at least one Delaware Chancery opinion.\(^{68}\) After all, the policy of encouraging wealth maximization through rationally based risk taking is not implicated when directors have not

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\(^{65}\) Kan. Stat. Ann. §§ 17-6301(e), -6422 (Supp. 2005); Smith v. Van Gorkom, 488 A.2d 858, 874–75 (Del. 1985); Principles of Corporate Governance, supra note 15, §§ 4.01(a), (b), 4.02, 4.03.

\(^{66}\) Caremark, 698 A.2d at 970. See Aronson, 473 A.2d at 813 (stating that a conscious decision to refrain from acting may be a valid exercise of business judgment).

\(^{67}\) Caremark, 698 A.2d at 967 (emphasis omitted).

\(^{68}\) Rabkin v. Philip A. Hunt Chem. Corp., No. Civ. A 7547, 1987 WL 28436, at *3 (Del. Ch. Dec. 17, 1987); Principles of Corporate Governance, supra note 15, § 4.01(a), (c), cmt. c. The Rabkin court analyzed the issue as follows:

The question remains whether the standard of care applied to directors who attempt to exercise their business judgment also applies to those who abdicate their managerial responsibility in whole or in part. I think not. As I read Smith v. Van Gorkom, and the cases cited therein, the gross negligence standard is really a corollary to the business judgment rule. As the Court noted in Van Gorkom, "[t]he business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors." Consistent with the wide latitude granted to them under the business judgment rule, directors who undertake their decision making responsibility will not be held liable either for a fault in the decision making process or the decision itself unless they were grossly negligent. It does not seem logical to accord the same deference to directors who abdicate their managerial responsibilities. There would be little meaning to the business judgment rule if, in cases not implicating the duty of loyalty, directors were given the same protection from liability whether it applies or not. Accordingly, I conclude that ordinary negligence is the appropriate standard of liability in director neglect claims.

Rabkin, 1987 WL 28436, at *3 (citations omitted).
made a conscious business decision of any sort. 69 On the other hand, Delaware’s Supreme Court precedent is ambivalent, 70 and several Chancery opinions conclude that something more than ordinary negligence is the appropriate standard in cases involving failure to monitor as well as in cases falling under the business judgment rule. 71 These decisions are supported, explicitly or implicitly, by the view that the policy of the law should be to encourage qualified people to assume directorships by freeing them from fear of liability for all but the grossest breaches of the duty of care. 72

69. Principles of Corporate Governance, supra note 15, § 4.01(c) cmt. c. states, there is, however, no reason to provide special protection where no business decision making is to be found. If, for example, directors have failed to oversee the conduct of the corporation’s business . . . by not even considering the need for an effective audit process, and this permits an executive to abscond with corporate funds, business judgment rule protection would be manifestly undesirable. The same would be true where a director received but did not read basic financial information, over a period of time, and thus allowed his corporation to be looted. In these and other “omission” situations, the director or officer would be judged under the reasonable care standards of § 4.01(a) and not protected by § 4.01(c).

70. The court in Graham v. Allis-Chalmers Manufacturing Co. stated the standard as “that amount of care which ordinarily careful and prudent men would use in similar circumstances.” 188 A.2d 125, 130 (Del. 1963). However, the court elaborated as follows:

In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability on him. This is not the case at bar, however . . . .

Id. (emphasis added).

71. In re Walt Disney Co. Derivative Litig., No. Civ.A.15452, 2005 WL 2056651, at *32 (Del. Ch. Aug. 9, 2005) (“gross negligence”); Caremark, 698 A.2d at 971 (requiring “lack of good faith as evidenced by sustained or systematic failure . . . to exercise reasonable oversight”). Cf. Seminari v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995) (holding demand on directors not excused in derivative action because complaint failed to allege with particularity facts that would demonstrate directors were grossly negligent in failing to supervise subordinates); In re Baxter Int’l, Inc. S’holders Litig., 654 A.2d 1268, 1270 (Del. Ch. 1995) (holding demand on directors not excused in derivative action because allegations of gross negligence and recklessness in failing to supervise were not sufficiently particularized); Lutz v. Boas, 171 A.2d 381, 395–96 (Del. Ch. 1961) (finding, but not necessarily requiring, gross negligence in failure to monitor). I R. Franklin Balloti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations § 4.18 (3d ed. 1998) states that something more than ordinary negligence is required, whether it be termed gross negligence, recklessness or something else.

72. The Caremark court articulated this policy as follows:

[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.

The state of the case law in Kansas is not dissimilar. In Speer v. Dighton Grain, Inc., the court stated the standard of care as "that measure of attention, care, and ability which the ordinary director and officer of corporations of this kind would be reasonably and properly expected to bestow upon the affairs of the corporation." Yet the directors’ failure to monitor the activities of a dishonest vice president, even after specifically being warned by the corporation’s outside auditor, was so extreme that the case was tried and argued on appeal as involving gross negligence.


In the 1985 decision of Smith v. Van Gorkom, the Delaware Supreme Court shocked the corporate world by holding that disinterested but grossly uninformed directors who approved a disadvantageous merger were not entitled to the protection of the business judgment rule and thus faced the prospect of an adverse multimillion dollar personal judgment. The reaction of the Delaware legislature was swift. In 1986 it amended its corporation law to add section 102(b)(7). That section permits a corporation’s certificate of incorporation to contain a provision limiting or eliminating a director’s personal liability for monetary damages for breach of fiduciary duty, with the exception of liability for: (1) breach of duty of loyalty; (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; (3) unlawful distributions; or (4) any transaction from which the director received an improper personal benefit. In other words, the statute permits a provision in the certificate of incorporation that eliminates personal liability for money damages for breach of the duty of care.

74. Id. at 276, 624 P.2d at 955–56.
75. Id.
76. 488 A.2d 858 (Del. 1985).
78. Technically, the statute permits only limitation or elimination of the damages remedy, not the underlying duty of care itself. Emerald Partners, 787 A.2d at 92; Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001). As a practical matter, one would not expect to encounter many cases in which a plaintiff sought to enjoin a breach of the duty of care. Ironically, Malpiede itself is an example. Plaintiffs originally sought to enjoin the disputed merger, but the court refused to issue a temporary restraining order, the merger closed, and the case devolved into an action for damages. Id. at 1081–82.
Kansas followed suit by amending its statute to adopt an identical provision the following year.\textsuperscript{79}

The purpose of these statutes is to permit shareholders affirmatively to "encourag[e] capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith business decisions without fear of personal liability."\textsuperscript{80} That is, the policy is an extension of that underlying the business judgment rule, but it is clear that exculpatory clauses will also insulate directors from claims that they have failed to monitor adequately management of the business.\textsuperscript{81}

Delaware views these exculpatory provisions as "in the nature of" affirmative defenses,\textsuperscript{82} with the result that failure to assert them amounts to a waiver.\textsuperscript{83} If properly asserted, however, they require dismissal of a complaint that pleads nothing more than a breach of the duty of care.\textsuperscript{84}

\subsection*{B. Partnerships}

Nationally, before promulgation of the Revised Uniform Partnership Act, there was a division of authority regarding the standard of care to which partners were held in managing the business. The traditional view, to which Kansas subscribed, imposed liability on partners for ordinary negligence with respect to both their business decisions and their supervisory activities.\textsuperscript{85} The modern trend elsewhere, however, looked to corporate law and applied the business judgment rule. The
effect was to adopt a gross negligence standard, at least as to partners’ business decisions that turned out badly.\textsuperscript{86}

When Kansas enacted the Revised Uniform Partnership Act,\textsuperscript{87} it codified this modern trend, as follows:

A partner’s duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.\textsuperscript{88}

This standard of care, of course, equates partnership law with that applicable to corporate directors. Although it is true that the policy of encouraging qualified persons to serve as directors is inapplicable, the policy of freeing business persons to make profit-maximizing decisions is equally applicable, with a slightly different twist.

One of the hallmarks of partnership law is the norm that partners share profits and losses.\textsuperscript{89} If this norm is combined with a standard of care that is breached only by gross negligence or worse conduct, then losses caused by a partner’s ordinary negligence will be borne by all partners like any other loss, rather than being allocated exclusively to the acting partner. If all partners are active in the business and subject to similar risks in their management activities, they probably would prefer this result to one that visited the consequences of ordinary negligence solely on the actor.\textsuperscript{90}

If partners want a more stringent standard of care, they are free to provide for it in their partnership agreement.\textsuperscript{91} They may also reduce the


\textsuperscript{87} Ch. 93, 1998 Kan. Sess. Laws 393 (effective Jan. 1, 1999) (codified at KAN. STAT. ANN. §§ 56a-101 to -1305 (2005)).

\textsuperscript{88} KAN. STAT. ANN. § 56a-404(c) (2005). General partners of limited partnerships are subject to the same duty of care because of the linkage between the partnership act and the limited partnership act. KAN. STAT. ANN. §§ 56-1a253(a), (c), -1a604 (2005).

\textsuperscript{89} Unless otherwise agreed, partners share profits and losses equally. KAN. STAT. ANN. §§ 56a-103(a), -401(b) (2005). This sharing is typically accomplished by means of partners’ accounts, which are credited with each partner's share of profits and charged with the partner's share of losses. § 56a-401(a).


\textsuperscript{91} § 56a-103(a); REVISED UNIF. P'SHIP ACT § 103 cmt. 6 (1997).
statutory standard as long as the reduction is not unreasonable.92 The line of demarcation between reasonable and unreasonable reductions in the duty of care has yet to be drawn. The drafters of the Revised Uniform Partnership Act state that “provisions releasing a partner from liability for actions taken in good faith and in the honest belief that the actions are in the best interests of the partnership” are authorized, but that a provision “absolving partners of intentional misconduct is probably unreasonable.”93 This indicates fairly clearly that an analogy to the corporate exculpatory provisions discussed above is not inappropriate.94 Such an analogy would disallow partnership exculpation of both intentional misconduct and knowing violations of the law.95 On the other hand, a partnership agreement that immunizes partners from the consequences of gross negligence would be permissible.

Whether that immunity could be extended to recklessness is more problematic. Recklessness might be seen as either an extreme form of negligence or a lesser form of knowing or intentional conduct. To the extent it is viewed as the former, recklessness would not necessarily be inconsistent with subjective good faith, and thus would be subject to exculpation in a corporation’s charter, or by analogy, in a partnership agreement. However, to the extent recklessness is seen as involving a conscious disregard of a known undue risk, it is qualitatively different than even very gross negligence. As such, it would amount to a lack of good faith that could not be protected either by a corporate charter or a partnership agreement.96

92. § 56a-103(b)(4).
93. ... P’SHIP ACT § 103 cmt. 6.
94. See supra Part III.A.3.
95. Compare KAN. STAT. ANN. § 17-6002(b)(8)(B) (Supp. 2005) (stating that articles of incorporation may not eliminate or limit director’s liability for bad faith acts, intentional misconduct, or a knowing violation of law), with KAN. STAT. ANN. § 56a-404(c) (2005) (stating that a partner’s duty of care is limited to refraining from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law).
96. McCall v. Scott, 239 F.3d 808, 817–19 (6th Cir. 2001) (applying Delaware law); 1 BALLOTTI & FINKELSTEIN, supra note 71, § 4.29, at 4-119. Professor Sale persuasively argues that the case law defining “sciente” under the federal securities laws that prohibit insider trading should be used to give content to “good faith” under Delaware law. This view equates recklessness with the kind of extreme or deliberate indifference that is incompatible with good faith. Hillary A. Sale, Delaware’s Good Faith, 89 CORNELL L. REV. 456, 488–94 (2004). See infra Part IV for further discussion of the duty of good faith. The Delaware partnership and limited partnership statutes differ radically from their uniform and Kansas counterparts, in that the Delaware statutes permit partnership agreements to eliminate completely any and all liability for breach of fiduciary duties. DEL. CODE ANN. tit.6, §§ 15-103(f), 17-1101(d), (f) (2005). Similar provisions appear in Delaware’s limited liability company act, section 18-1101(c), (e), and will be discussed infra Part V.C.
C. Limited Liability Companies

Unlike partnership law, there is no statutory duty of care applicable to the members and managers of Kansas limited liability companies.\(^\text{97}\) Nevertheless, in *Carson v. Lynch Multimedia Corp.*,\(^\text{98}\) the court implicitly  imported the Delaware corporate business judgment rule into the law of Kansas limited liability companies, but held it inapplicable to managers’ actions taken for reasons wholly unrelated to the business.\(^\text{99}\) In addition, in *Blackmore Partners, L.P. v. Link Energy LLC*,\(^\text{100}\) the Delaware Court of Chancery applied the classic corporate business judgment rule in granting summary judgment for the defendant directors of a limited liability company in the face of a challenge to their decision to sell the company’s assets.\(^\text{101}\) In doing so, the court necessarily found that there was no genuine dispute that both the directors’ decisional process and ultimate decision fell short of gross negligence.\(^\text{102}\)

This readiness to analyze decision-making in limited liability companies by reference to corporate law leaves little doubt that courts will take the same approach with reference to the oversight function. Section 17-7697 of the Kansas Revised Limited Liability Company Act (KRLACA) reinforces this conclusion.\(^\text{103}\) Like its corporate counterparts,\(^\text{104}\) it protects a member or manager who relies in good faith on a limited liability company’s records and on other information, opinions, reports, or statements of its other members, managers, officers, employees, or committees, or of any other person who has been selected with reasonable care, as to matters the member or manager reasonably believes are within the person’s professional or expert competence.\(^\text{105}\)

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\(^{97}\) Cf. *Unif. Ltd. Liab. Co. Act* § 409(c), (h) (1996) (codifying members’ and managers’ duty of care as limited to refraining from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law).


\(^{101}\) Id. at *5 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

\(^{102}\) Id. at *8.


\(^{105}\) § 17-7697. The statute specifically extends protection to good faith reliance on financial information affecting the legality of distributions by a limited liability company to its members.
It is also apparent that members and managers of Kansas limited liability companies can contract out of the duty of care at least to the same extent as corporate directors and partners in partnerships. The KRLCAA postulates that its policy is to give maximum effect to freedom of contract and the enforceability of operating agreements. Moreover, it affirmatively provides that to the extent a member or manager has fiduciary or other duties and liabilities, such duties and liabilities may be expanded or restricted by the operating agreement, and the member or manager will not be liable for acting in good faith in reliance on the operating agreement. A similar provision in Delaware’s statute validated an operating agreement that exculpated a limited liability company’s directors from damage awards based on breach of their duty of care. As such, it replicated Delaware and Kansas corporate law.

IV. DUTY OF GOOD FAITH

A. Corporations

There is no doubt that good faith has always been an element of the duty of care. Thus, the classic statement of the business judgment rule is that “[i]t is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Similarly, the Delaware Court of Chancery has articulated the kind of inattention that will incur liability with respect to the monitoring function as “lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight.” Moreover, in performing their managerial functions, directors are entitled to rely on information, opinions, reports, and statements of board committees, officers, and employees, provided such reliance is “in good faith.”

107. § 17-76,134(e).
109. See supra Part III.A.3. Delaware has since radically liberalized its partnership, limited partnership, and limited liability company statutes. See infra Part V.C.
Good faith is also a baseline condition of the duty of loyalty. The leading Kansas case of *Newton v. Hornblower, Inc.*,\(^{113}\) stated the common law rule governing directors’ and officers’ self-dealing contracts and transactions as follows:

Any unfair transaction induced by a fiduciary relationship between the parties gives rise to a liability with respect to unjust enrichment of the fiduciary. Where such transaction is attacked, the burden of proof is on the fiduciary to establish the fairness of the transaction, and to this end he must fully disclose the facts and circumstances, and affirmatively show his *good faith*. Where the fairness of the transaction is challenged, there must be an affirmative showing of fairness and *good faith*...\(^{114}\)

The statutory law governing such transactions likewise requires that they be authorized "*in good faith*."\(^{115}\)

Recently, however, Delaware courts seem to have started viewing good faith as a third, separate, free-standing fiduciary duty. Thus, in *Cede & Co. v. Technicolor, Inc.*,\(^{116}\) the court stated that, to rebut the presumption of the business judgment rule, "a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care."\(^{117}\) It is not entirely clear whether the *Cede* court actually intended to break with the past and recast good faith as a third, separate fiduciary duty, or whether it has been misread as doing so when it merely intended good faith as a synonym for loyalty.\(^{118}\) Nevertheless, several additional Delaware decisions have embraced the concept of a triad of fiduciary duties of good faith, loyalty, and due care.\(^{119}\) Whether viewed as a separate fiduciary duty, a synonym for loyalty, or a bridge or overarching concept that connects care and


\(^{114}\) *Id.* at 518, 582 P.2d at 1146 (citations omitted) (emphasis added).

\(^{115}\) KAN. STAT. ANN. § 17-6304(a)(1), (2) (1995) (emphasis added). See infra Part V.A for further discussion of this provision.

\(^{116}\) 634 A.2d 345 (Del. 1993).

\(^{117}\) *Id.* at 361.


loyalty, the primary practical importance of good faith is that conduct not in good faith is not subject to exculpation under a section 102(b)(7) charter provision.

The duty of loyalty traditionally has been confined to situations in which a director, officer, or controlling shareholder has a pecuniary, self-dealing conflict of interest with the corporation or minority shareholders. Because Delaware General Corporation Law section 102(b)(7) and Kansas General Corporation Code section 17-6002(b)(8) exclude both breaches of duty of loyalty and conduct not in good faith from exculpation, good faith finds its most significant application in situations that do not involve loyalty as traditionally cast. In other words, the concept of good faith is most important with respect to non-self-dealing director decisions that are so egregious that they are explainable only on the basis of bad faith, or in cases that involve such sustained and systematic lack of oversight that they amount to complete abdication of all directorial responsibility.

120. See Reed & Neiderman, supra note 118, at 119–24 (discussing different interpretations of "good faith"); Sale, supra note 96, at 463–64 (discussing emerging good faith doctrine); Veasey & Di Guglielmo, supra note 53, at 1449–51 (discussing whether good faith is a separate duty).


122. See, e.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (discussing when the business judgment rule can apply); Sinclair Oil Corp. v. Leven, 280 A.2d 717, 720 (Del. 1971) (same); Veasey & Di Guglielmo, supra note 53, at 1451 (stating that the preferable approach is to treat good faith and loyalty separately because self-dealing is unnecessary for a good faith violation).

123. Tit. 8, § 102(b)(7)(i), (ii), § 17-6002(b)(8)(A), (B).

124. See Veasey & Di Guglielmo, supra note 53, at 1451. See also Reed & Neiderman, supra note 118, at 124–40 for an extensive discussion of both types of cases. If one does not accept good faith as a third, separate fiduciary duty, and if one confines the duty of loyalty to situations that involve self-dealing, then the cases mentioned in the text necessarily must be categorized under the rubric of duty of care. If these cases are found to constitute conduct not in good faith, there is at least a superficial inconsistency with holdings such as that in Malpiede v. Townson, 780 A.2d 1075 (Del. 2001). In Malpiede, the court summarized the law as follows: "Our jurisprudence since the adoption of the statute has consistently stood for the proposition that a Section 102(b)(7) charter provision bars a claim that is found to state only a due care violation." Id. at 1095. Although the difficulty is really only semantic, a solution would require rephrasing the rule as "a Section 102(b)(7) charter provision bars a claim that is found to state only a good faith due care violation." See Reed & Neiderman supra note 118, at 114 (describing section 102(b)(7) as exculpating either only pure duty of care violations or only some duty of care violations). Problems such as this are avoided by acceptance of good faith as a free-standing fiduciary duty. The Delaware Supreme Court recently identified a category of fiduciary misconduct that does not involve loyalty, as classically defined, but is more culpable than gross negligence. In re Walt Disney Co. Derivative Litig., No. 411,2005, 2006 WL 1562466, at *26 (Del. June 8, 2006). Examples include reckless indifference to, or deliberate disregard of, the interests of the shareholders; sustained or systematic failure to exercise oversight, such as utter failure to assure a reasonable information and reporting system exists; and conscious disregard of duties to the corporation and shareholders. Id. at *27 n.111. The court held that the duty to act in good faith was the appropriate vehicle to address such misconduct. Id. at *26. However, it declined to decide whether good faith is a third, separate, liability-producing fiduciary duty, independent of care and loyalty. Id. at *27 n.112.
Perhaps the most exhaustive judicial examination of the duty of good faith to date bridges the gap between these two types of cases and involves the hiring and subsequent termination of Michael Ovitz as president of the Walt Disney Company. In the first of two major opinions, the Delaware Court of Chancery held that the well-pleaded factual allegations of the plaintiffs’ complaint stated a cause of action for breach of the duty of good faith that was not protected by either the business judgment rule or the section 102(b)(7) exculpatory provision in the Disney certificate of incorporation. These allegations, which the court was required to assume were true for purposes of the motion to dismiss, are set out below.

Disney was in need of a second-in-command and successor to its current CEO and chairman, Michael Eisner. Eisner unilaterally decided that the best person for the job was Michael Ovitz, Eisner’s friend of twenty-five years. Initial discussions between Eisner and Ovitz produced a draft agreement. A written summary of the basic terms of this agreement, but not the actual document, was considered and approved first by the board’s compensation committee and then by the full board at two relatively short meetings on September 26, 1995. The compensation committee was informed that the agreement was not complete and that further negotiations would occur. The committee approved the general terms and conditions as summarized but did not review the final agreement. Instead, it delegated authority to Eisner to approve the final version as long as it was within the framework of the summary of the draft. The full board met immediately thereafter without further documentation or even a report or recommendation from the compensation committee. Board members asked no questions regarding Ovitz’s prospective salary, stock options, termination, or the financial consequences of termination. Rather, the board simply decided to appoint Ovitz as president and leave negotiation of the final terms of the employment agreement to Eisner. Ovitz was hired and began work as president of Disney almost immediately, even though the employment agreement was not finalized for another two and one-half months. As finalized, the agreement differed significantly (in Ovitz’s favor), with respect to stock options and nonfault termination, from the summaries provided to the compensation committee.

126. Id. at 289–90.
127. Id. at 279.
128. Id. at 280.
129. Id. at 281.
Ovitz quickly proved to be a bad choice, and Eisner realized it. Ovitz lacked the knowledge and experience necessary for a senior executive at a major, publicly held company, and he was unwilling to learn. When prospects for other employment proved fruitless, Ovitz and Eisner began negotiating a formal, nonfault termination under Ovitz's employment agreement. Although the Disney board was aware of this development, neither the board nor the compensation committee was consulted about or gave approval for the nonfault termination, under which Disney paid Ovitz $38.8 million and awarded him options to purchase three million shares of Disney stock.

Assuming the truth of these allegations, the court held that they were sufficient to excuse the derivative suit requirement of a demand on the directors and to withstand the defendants' motion to dismiss the complaint. In doing so, the court stated its view of the duty of good faith:

These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs' new complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant directors' conduct fell outside the protection of the business judgment rule.

I also conclude that plaintiffs' pleading is sufficient to withstand a motion to dismiss under Rule 12(b)(6). Specifically, plaintiffs' claims are based on an alleged knowing and deliberate indifference to a potential risk of harm to the corporation. Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either "not in good

130. Id. at 283.
131. Id. at 284–85.
faith” or “involve intentional misconduct.” Thus, plaintiffs’ allegations support claims that fall outside the liability waiver provided under Disney’s certificate of incorporation.  

Slightly more than two years later, after a trial on the merits, in a ninety-page opinion, the court somewhat apologetically exonerated the Disney directors.  

Before doing so, the court restated its view of good faith:

Upon long and careful consideration, I am of the opinion that the concept of intentional dereliction of duty, a conscious disregard for one’s responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.

. . . A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

Throughout the opinion, the court viewed good faith as purely a subjective concept.  

With respect to Ovitz’s hiring, the compensation committee and the full board each made a business judgment on September 26, 1995. Disney’s governing documents required full board approval for hiring officers, with compensation being established by the compensation committee. That, according to the court, is exactly what happened. The compensation committee acted on the basis of a

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132.  Id. at 289–90 (footnotes omitted).
133.  In re Walt Disney Co. Derivative Litig., No. Civ. A. 15452, 2005 WL 2056651, at *52 (Del. Ch. Aug. 9, 2005). In the first of several apologies, Chancellor Chandler introduced his opinion, as follows:

As I will explain in painful detail hereafter, there are many aspects of defendants’ conduct that fell significantly short of the best practices of ideal corporate governance. Recognizing the protean nature of ideal corporate governance practices, particularly over an era that has included the Enron and WorldCom debacles, and the resulting legislative focus on corporate governance, it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced.

Id. at *1.

134.  Id. at *36 (citations omitted).

135.  See, e.g., id. at *41 (concluding that Eisner’s actions were taken in good faith because Eisner believed his actions were in the best interests of the company).

136.  Id. at *40 (noting that Ovitz’s hiring was discussed and voted upon on September 26).
fact sheet prepared by an expert on whom they were entitled by statute to rely in good faith.\textsuperscript{137}

The compensation committee had no duty to act after that date. Given the size and complexity of Disney's business, its affairs could not realistically actually be managed by its board of directors or even by a board committee. Management necessarily had to be by Disney's senior executives under the ultimate supervision of the board.\textsuperscript{138} The compensation committee's resolution contemplated that some details had yet to be agreed upon, but none of them were material.\textsuperscript{139} The full board's only duty under Disney's governing documents was to elect Ovitz as president. It had no duty to analyze independently the terms of his employment agreement and its provisions for compensation. Accordingly, its members could not have disregarded a known duty for failing to have done so.\textsuperscript{140}

The concept of lack of good faith as the conscious disregard of a known duty to act is also the key to the court's handling of Ovitz's termination and severance package. Reading Disney's certificate of incorporation and by-laws together, the court concluded that the board and the CEO each had the concurrent but severally exercisable power to terminate lesser officers. Therefore, the board had the right, but not the duty, to act regarding Ovitz's termination. Because there was no duty to act, good faith was simply not an issue. The board was entitled to rely on Eisner as CEO. Eisner, in turn, relied in good faith on the opinion of the company's general counsel that terminating Ovitz for cause was not legally possible. Therefore, Eisner, in good faith pursuit of what he honestly believed was in the best interest of the company, agreed to nonfault termination pursuant to the terms of Ovitz's employment contract.\textsuperscript{141}

\textsuperscript{137} See Del. Code Ann. tit. 8, § 141(e) (2001) (providing that a director may rely in good faith upon statements of experts who have been selected with reasonable care); Kan. Stat. Ann. § 17-6301(e) (Supp. 2005) (same).

\textsuperscript{138} Tit. 8, § 141(a); § 17-6301(a). See also supra Part III.A.2 (noting that as the size of a corporation grows, hands-on management by the board is less possible).

\textsuperscript{139} Disney, 2005 WL 2056651, at *40-47.

\textsuperscript{140} Id. at *47.

\textsuperscript{141} Id. at *47-51. The Delaware Supreme Court recently affirmed the Court of Chancery's decision on the merits in all respects. In re Walt Disney Co. Derivative Litig., No. 411,2005, 2006 WL 1562466, at *1, 34 (Del. June 8, 2006). In doing so, the court found no substantive difference between the Chancellor's definition of conduct not in good faith in his decision on the sufficiency of the complaint in 2003 and his decision on the merits in 2005. Id. at *24. That definition addresses conduct that is more culpable than gross negligence but that falls short of subjective bad faith in the sense of an affirmative intent to do harm. Id. at *26. It is a legally appropriate, although not exclusive, definition of conduct that is not in good faith and that, therefore, is not subject to exculpation under section 102(b)(7). Id. at *27.
As described above, Delaware shocked the corporate world in 1985 when *Smith v. Van Gorkom* held that disinterested but grossly uninformed directors could not claim the protection of the business judgment rule. The immediate legislative response was enactment of section 102(b)(7), which authorizes charter provisions that exculpate directors from damage liability for breach of their duty of care but not for conduct not in good faith. In the wake of widespread adoption of such exculpatory provisions, the predictable response of the plaintiffs' bar was to plead cases as involving lack of good faith whenever possible. Having started down that road in 2003, the *Disney* Court of Chancery’s retrenchment in 2005 may best be understood as an attempt to avoid at all costs a reprise of the *Van Gorkom* debacle on its twentieth anniversary.

**B. Partnerships**

Because Kansas law codifies the duties of care and loyalty as the exclusive fiduciary duties of partners, it is clear that good faith is not a separate, free-standing fiduciary duty. Nevertheless, in addition to the fiduciary duties of care and loyalty, each partner owes the partnership and the other partners a statutory obligation of good faith and fair dealing in discharging any duties or in exercising any rights under either the Kansas Revised Uniform Partnership Act or the partnership agreement. Unlike a fiduciary duty, the obligation of good faith and fair dealing is contract-based rather than status-based. Moreover, it is not an independent duty, but rather an ancillary obligation that the law superimposes on the manner in which partners perform other duties or exercise rights.

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142. Supra Part III.A.3.
143. 488 A.2d 858 (Del. 1985).
146. § 56a-404(d). Once again, this provision applies equally to general partners of limited partnerships because of the linkage between the statutes governing the two forms of partnership. See §§ 56-1a253(a), (c), -1a604.
147. Revised Unif. P'Ship Act § 404 cmt. 4 (1997). The obligation of good faith and fair dealing is derived from Restatement (Second) Of Contracts § 205 (1981). Id. Kansas case law implies the Second Restatement’s covenant of good faith and fair dealing in every contract except those relating to employment at will. Kan. Baptist Convention v. Mesa Operating Ltd. P'Ship, 253 Kan. 717, 724–26, 864 P.2d 204, 210–12 (1993). Thus, the statutory partnership version is essentially redundant, but at least it highlights in context that each partner must act fairly and in good faith as to all matters connected to the partnership.
The drafters of this statutory obligation have noted that “good faith” suggests a subjective inquiry and “fair dealing,” an objective focus, but beyond this they have intentionally left the meaning and application of the obligation open for judicial development.149 We do know, however, that they rejected the Uniform Commercial Code’s definition of “honesty in fact” as too narrow.150

Section 205 of the Restatement (Second) of Contracts151 is the source of both the statutory partnership obligation of good faith and fair dealing and also its generally applicable case law counterpart. The Comments to the Second Restatement provide, in general:

Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness.152

The focus on faithfulness to, and consistency with, the justified or reasonable expectations of the other party is supported by a line of limited partnership cases in Delaware,153 and also parallels recent developments in the law of closely held corporations.154

To some extent, advance planning can provide individually tailored content to the obligation of good faith and fair dealing. That is, although

149. Id.
150. Id.
151. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). This section provides, “Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” Id.
152. Id. cmt. a. With specific reference to performance, the comments go on to provide as follows:

Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.

Id. cmt. d.
the partnership agreement cannot completely eliminate this obligation, it can provide standards by which performance will be measured, as long as the standards are not manifestly unreasonable.155

C. Limited Liability Companies

Unlike the Kansas Revised Uniform Partnership Act, the Kansas Revised Limited Liability Company Act does not codify an obligation of good faith and fair dealing.156 Nevertheless, limited liability companies are highly contractual in nature,157 and Kansas case law implies a covenant of good faith and fair dealing in all contracts other than those relating to employment at will.158 Therefore, members and managers of Kansas limited liability companies are subject to the obligation of good faith and fair dealing, and it will be applied in a manner analogous to partnership law. At present, however, there is even less case law

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155. Kan. Stat. Ann. § 56a-103(b)(5) (2005). Delaware takes a different tack. Its general and limited partnership acts both provide that a partnership agreement may expand, restrict, or completely eliminate partners' duties, including fiduciary duties, except that the agreement may not eliminate the implied contractual covenant of good faith and fair dealing nor limit or eliminate liability for a bad faith violation of the implied covenant. Del. Code Ann. tit. 6, §§ 15-103(b)(3), (f), 17-1101(d), (f) (2005).

156. Section 409(d) of the Uniform Limited Liability Company Act (1996), which is not in force in Kansas, is such a codification. Unif. Ltd. Llb. Co. Act § 409(d) (1996), 6A U.L.A. 600 (2003). Delaware takes a different tack. Its limited liability company act provides that a limited liability company agreement may expand, restrict, or completely eliminate members' and managers' duties, including fiduciary duties, except that the agreement may not eliminate the implied contractual covenant of good faith and fair dealing nor limit or eliminate liability for a bad faith violation of the implied covenant. Del. Code Ann. tit. 6, § 18-1101(c), (e) (2005).

157. See, e.g., Kan. Stat. Ann. § 17-76,134(b) (Supp. 2005) ("It is the policy of this act to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."). In keeping with this principle, the overwhelming majority of the Kansas act's provisions concerning internal matters are simply default rules, subject to change by a limited liability company's operating agreement. For example, the following matters may be affected by provisions in an operating agreement: business transactions of members and managers with a limited liability company; indemnification; approval of mergers, consolidations and conversions; appraisal rights; assignment of limited liability company interests and admission of members; classes, voting and other rights of members and managers; the effect of bankruptcy on a person's status as a member; standards governing access to information; remedies for breach of the agreement; management norms; selection, admission and termination of managers; the status of a person who is both a member and manager; delegation of managerial powers; liability for capital contributions; allocation of profits, losses and distributions; rights and obligations regarding distributions; dissolution, winding up and liquidation distributions; and fiduciary and other duties. Kan. Stat. Ann. §§ 17-7669, -7670, -7681, -7682, -7685 to -7687, -7689 to -7696, -7698, -76,100 to -76,102, -76,104 to -76,109, -76,112, -76,114, -76,116, -76,118, -76,119, -76,134 (Supp. 2005).

defining the parameters of this obligation in the context of limited liability companies than there is in the context of partnerships.\textsuperscript{159}

V. DUTY OF LOYALTY

A. Corporations

1. Self-Dealing Contracts and Transactions

"Self dealing" should not be understood as a prejudgment of the merits or even as a necessarily derogatory term. In the present context, it simply describes a factual situation in which a corporate fiduciary (director, officer, or controlling shareholder) appears on both sides of a contract or transaction with the fiduciary's corporation, or otherwise receives from the transaction an exclusive or disproportionate financial benefit.\textsuperscript{160} Quite literally, "self dealing" means "dealing with oneself."

\textsuperscript{159} As in the corporate context, good faith constitutes a necessary element of the fiduciary duties of care and loyalty. Thus, a business decision by disinterested managers that is so egregious that it amounts to waste can be found to have been made in bad faith and for that reason fall outside the protection of the business judgment rule. See Blackmore Partners, L.P. v. Link Energy LLC, No. Civ.A. 454-N, 2005 WL 2709639, at *8 (Del. Ch. Oct. 14, 2005) ("[T]he subjective bad faith of directors may be inferred from corporate actions which are so egregious as to be afforded no presumption of business judgment protection."). Moreover, managers' acts done in technical compliance with the law governing limited liability companies but for the purpose of diluting a member's equity interest, amount to bad faith breaches of the duty of loyalty. See Solar Cells, Inc. v. True North Partners, LLC, No. Civ.A. 19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002) ("[I]t is not an unassailable defense to say that what was done was in technical compliance with the law."); VGS, Inc. v. Castiel, No. Civ.A. 17995, 2000 WL 1277372, at *4-5 (Del. Ch. Aug. 31, 2000), aff'd, 781 A.2d 696 (Del. 2001). Finally, in Flight Options Int'l, Inc. v. Flight Options, LLC, the court noted that the implied contractual covenant of good faith and fair dealing was unwaivable but satisfied by managers' reasonable belief that their action was in the best interest of the limited liability company. No. Civ.A. 1459-N, 2005 WL 2335353, at *7, 9 n.42 (Del. Ch. Sept. 20, 2005). See generally Altman & Raju, supra note 153.

\textsuperscript{160} Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). There is a significant body of Delaware case law dealing with the duties of corporate directors in the context of hostile takeovers. The transactions in such cases usually do not involve self-dealing in that the directors do not have a personal financial interest in the transaction that is adverse to the corporate interest. The directors typically do, however, have a personal interest in protecting their directorships, and that interest may well be at odds with the shareholders' interest in maximizing the value of their shares via the hostile offer. Complicating matters further, the directors have a duty to protect the corporation from threats to good business policy and effectiveness. Because of these competing considerations, a complex hybrid analysis has developed that is beyond the scope of this Article. For an excellent current exposition of Delaware law as applied in Kansas, see Burcham v. Unison Bancorp, Inc., 276 Kan. 393, 417-23, 77 P.3d 130, 147-51 (2003), and authorities cited therein. See also Annette Simon, Note, MM Companies, Inc. v. Liquid Audio, Inc.: An Attempt to Clarify the Blasius-Unocal Framework, 52 U. KAN. L. REV. 1153 (2004) (analyzing the further complications involved if the directors' response to the takeover threat disenfranchises the corporation's shareholders).
Under normal circumstances, the business judgment rule raises a presumption that in making a business decision the directors of a corporation were informed of all material information reasonably available to them and that they acted in the good faith and honest belief that the decision was in the corporation's best interest.\textsuperscript{161} Consequently, the burden is on the party challenging the decision to establish facts that either rebut the presumption or demonstrate that the decision was so egregious that it amounted to an abuse of discretion.\textsuperscript{162}

The situation is much different, however, if the decision is to authorize a self-dealing contract or transaction. Because, by definition, a corporate fiduciary receives or expects to receive a benefit that is not available to other similarly situated shareholders, the transaction is inherently suspect as one in which the fiduciary may be profiting at the expense of the corporation or other shareholders. Thus, at common law, a director's self-dealing contract or transaction, if challenged, is not subject to review under the deferential business judgment rule.\textsuperscript{163} Instead, its merits are subject to strict judicial scrutiny under the so-called fairness standard, with the burden of proof on the interested director or directors to establish good faith and the intrinsic fairness of the transaction from the corporation's standpoint.\textsuperscript{164}

A major Delaware common law exception to the fairness rule involves disinterested shareholder ratification. That is, if the self-dealing transaction is submitted to a shareholder vote, and if, after disclosure of all material facts, the holders of a majority of the shares held by persons who are not interested in the transaction vote to approve it, the taint of interest is removed. The effect of such a disinterested ratification is to shift the standard of review back to the business judgment rule with the burden of proof on the party attacking the transaction to show waste—that no person of ordinary sound business judgment would view the terms as a fair exchange.\textsuperscript{165}

The policy underlying the disinterested shareholder ratification exception is quite sensible and straightforward. The business judgment rule is premised on the proposition that the interest of the corporation and its shareholders is best served by permitting the board of directors to make informed, good faith, honest, and unselfish business decisions free from being second-guessed by courts at the behest of minority

\textsuperscript{161} Aronson, 473 A.2d at 812.
\textsuperscript{162} Id. See also supra Part III.A.1.
\textsuperscript{163} Aronson, 473 A.2d at 812.
\textsuperscript{165} E.g., Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58–59 (Del. 1952).
shareholders. However, if those decisions are potentially selfish rather than unselfish, the interest of the corporation and its shareholders requires the added protection of scrutiny of the merits (second-guessing) by a disinterested, fully informed party (the court). If, however, the transaction has already been scrutinized and approved by disinterested, fully informed parties (the disinterested shareholders) further scrutiny by the court would be redundant. In other words, this exception views fairness as a process of scrutiny by disinterested, fully informed observers, and equates scrutiny by disinterested shareholders with scrutiny by a disinterested judge.

The Delaware Legislature approved this view and took it one step further when it recodified its corporate law in 1967. Unfortunately, as is true with many innovations in their first generation, there were defects.

Although there are minor grammatical and stylistic differences, section 144 of the Delaware General Corporation Law and section 17-6304 of the Kansas General Corporation Code are substantively identical. Section 144 provides,

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director’s or officer’s votes are counted for such purpose, if:

1. The material facts as to the director’s or officer’s relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

2. The material facts as to the director’s or officer’s relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

3. The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the

166. See supra Part III.A.1.
board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.\(^{167}\)

A complicated, interrelated, and somewhat disingenuous line of Delaware cases has construed section 144 to have the following effects. First, good faith, informed approval by a majority of the disinterested directors cures the self-dealing aspect of the transaction, and it will be reviewed under the business judgment rule with the burden of proof on the party attacking the transaction to show gross negligence or waste.\(^{168}\) In other words, section 144(a)(1) adds a third category of disinterested observers eligible to scrutinize carefully a self-dealing transaction: the disinterested directors. As long as they are truly disinterested, not dominated or controlled by the interested director or directors, and act in good faith, their scrutiny is considered to be an adequate substitute for scrutiny by a judge.\(^{169}\)

Second, good faith, informed approval by the holders of a majority of the voting shares held by disinterested parties also cures the self-dealing aspect of the transaction, and it will be reviewed under the business judgment rule with the burden of proof on the attacking party to show gross negligence or waste.\(^{170}\) In essence, Delaware courts interpret section 144(a)(2) as codifying the common law disinterested shareholder ratification rule even though the statute does not explicitly require the shareholder vote to be disinterested. This lapse in statutory drafting is a major defect in section 144. Although approval by disinterested

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170. *Cede & Co.*, 634 A.2d at 366 n.34; *Marciano*, 535 A.2d at 404–05 n.3. *Cf.* Fliegler v. Lawrence, 361 A.2d 218, 221–22 (Del. 1976) (holding that although section 144(a)(2) does not expressly require a disinterested shareholder vote, the statute does not cure the loyalty taint or remove the case from the strict fairness standard if the vote is interested). Note that, as with the director vote, an absolute disinterested majority is not necessary. All that is required is the affirmative vote of a majority of the shares held by shareholders who are disinterested. *Id.* at 221.
shareholders may be an adequate substitute for judicial approval such that the business judgment rule may be invoked, few would agree that strict judicial scrutiny for fairness should be foreclosed by the affirmative vote of interested shareholders. The Delaware courts have solved this problem by judicial legerdemain that amounts to superimposing a requirement of shareholder disinterest on section 144(a)(2).\textsuperscript{171} Happily, the Kansas Supreme Court has willingly, if somewhat awkwardly, followed suit.\textsuperscript{172}

Finally, only if the self-dealing transaction is neither approved by a majority of the disinterested directors nor by the holders of a majority of the voting shares held by disinterested parties is it required that the transaction be carefully scrutinized for fairness by the court. As under the common law, the burden of proof to demonstrate fairness under section 144(a)(3) is on the party seeking to uphold the transaction.\textsuperscript{173}

Delaware, however, distinguishes self-dealing contracts or transactions with a controlling shareholder,\textsuperscript{174} which technically are not covered by statute. Because control carries with it the potential for oppression, even disinterested directors or shareholders may feel subtly pressured in a way that prevents them from being able to safeguard the

\textsuperscript{171} At common law in the nineteenth century, a director's self-dealing contract was absolutely voidable, totally without regard to fairness or unfairness, solely because a director stood on both sides of the transaction. Harold Marsh, Jr., \textit{Are Directors Trustees? Conflict of Interest and Corporate Morality}, 22 BUS. LAW. 35, 36–39 (1966). By the middle of the twentieth century this rule had evolved into the familiar modern common law rule, under which a self-dealing contract is conditionally voidable unless shown by the interested director to be fair to the corporation. \textit{Id.} at 43–44. In \textit{Fliegler v. Lawrence}, the defendants noted the absence of an express disinterest requirement in section 144(a)(2), and argued that the statute validated a self-dealing transaction even if the shareholder ratification was interested. 361 A.2d at 222. The court's response was to focus on the introductory language of section 144(a) rather than the shareholder ratification procedure in subsection (a)(2). \textit{Id.} Reading subsection (a) literally, the court concluded that the legal effect of statutory compliance was merely to move the case out of the nineteenth century rule of absolute voidability and into the twentieth century fairness rule. \textit{Id.} That is, \textit{Fliegler} held that compliance with section 144 merely "provides against invalidation of an agreement 'solely' because such a director or officer is involved." \textit{Id.} (emphasis added). Thus, notwithstanding the interested shareholder ratification, it was still incumbent on the directors to establish common law fairness. \textit{Id.}

Eleven years later, in \textit{Marciano v. Nakash}, the court effectively rewrote the \textit{Fliegler} holding, as follows: "[S]ection 144 validation of interested director transactions is not deemed exclusive, as \textit{Fliegler} clearly holds . . . ." 535 A.2d 400, 404 (Del. 1987) (emphasis added). The court then surreptitiously added the disinterest requirement to subsection (a)(2) in its now-famous footnote 3: "[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof on the party attacking the transaction." \textit{Id.} at 405 n.3.


\textsuperscript{173} \textit{Marciano}, 535 A.2d at 405 n.3; \textit{Fliegler}, 361 A.2d at 221–22; \textit{Oberhelman}, 236 Kan. at 342–45, 690 P.2d at 1350–51.

\textsuperscript{174} See supra Part II.A (discussing the fiduciary status of controlling shareholders).
corporate interest adequately. Therefore, their approval is not viewed as a substitute for close judicial scrutiny of the merits of the transaction. That is, fairness remains the standard of review. At most, in a controlling shareholder self-dealing transaction, approval by disinterested directors or disinterested shareholders may shift the burden of proof to the party attacking the transaction to demonstrate its unfairness.¹⁷⁵

2. Use of Corporate Assets, Corporate Opportunities, and Competition

Basic concepts of duty of loyalty embodied in agency law require that an agent refrain from using a principal’s property for personal purposes, usurping a business opportunity that rightfully belongs to the

¹⁷⁵. Kahn v. Tremont Corp., 694 A.2d 422, 428–29 (Del. 1997); Kahn v. Lynch Commc’ns Sys., 638 A.2d 1110, 1115–18 (Del. 1994). Even a shift in the burden of proof is not automatic. If a committee of independent directors negotiates the transaction with the controlling shareholder, the controlling shareholder must not dictate the terms of the transaction, and the committee must have exercised real arm’s length bargaining power. Tremont, 694 A.2d at 429; Lynch, 638 A.2d at 1117–18. A parallel, but inconsistent, line of Delaware decisions recognizes an exception to universal application of the entire fairness standard when a controlling shareholder makes a tender offer for the minority’s shares, followed by a short-form merger in which any nontendering minority shareholders are cashed-out at the same price. Glassman v. Unocal Exploration Corp., 777 A.2d 242, 247–48 (Del. 2001); Solomon v. Pathe Commc’ns Corp., 672 A.2d 35, 39–40 (Del. 1996); In re Aquila Inc. S’holders Litig., 805 A.2d 184, 190–91 (Del. Ch. 2002); In re Siliconix Inc. S’holders Litig., No. Civ. A. 18700, 2001 WL 716787, at *6-8 & n.26 (Del. Ch. June 21, 2001). This disparate treatment is explainable, at least conceptually, on the basis that no action of the subsidiary’s board of directors is required to accomplish either step. The tender offer is a transaction solely between the controlling shareholder and the individual minority shareholders of the subsidiary. If the shares tendered, when added to the shares already owned, raise the controlling shareholder’s ownership of the subsidiary to at least ninety percent, it may merge the subsidiary into itself, and cash out the remaining minority, by a simple resolution of its board of directors. There is no necessity of any action by either the board of directors or the minority shareholders of the subsidiary. DEL. CODE ANN. tit. 8, § 253 (2001 & Supp. 2004); KAN. STAT. ANN. § 17-6703 (Supp. 2005). Thus, even the highly condensed respondent superior theory of controlling shareholder fiduciary duty is inapplicable in this context. See supra text accompanying notes 29–32. Nevertheless, at the policy level, the problem of inherent controlling shareholder oppression that underlies Lynch is equally present in the tender offer/short-form merger cases. Recognizing this similarity, the Delaware Court of Chancery has modified the Solomon line of cases by requiring that: (1) the tender offer is subject to the condition that at least a majority of the minority shares are tendered; (2) the controlling shareholder commits in advance to a short-form merger at the same price if it acquires ninety percent or more of the subsidiary’s shares; and (3) the controlling shareholder makes no retributive threats. In re Pure Resources, Inc. S’holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002). See also Peter V. Letsou & Steven M. Haas, The Dilemma That Should Never Have Been: Minority Freeze Outs in Delaware, 61 BUS. LAW. 25, 81–94 (2005) (arguing that both lines of cases should be merged and modified so that the business judgment rule, rather than the entire fairness standard, would apply to any freeze-out meeting all three of the following conditions: (1) the transaction is approved by a properly functioning committee of independent directors; (2) the transaction is effectively approved by the holders of a majority of the minority shares; and (3) the controlling shareholder has met its obligation of full and fair disclosure of all material facts and has not engaged in any coercive or otherwise illegal conduct).
principal, or competing with the principal while the agency relationship is ongoing. These duties are closely related and frequently overlap, such that an agent may breach more than one of them in a single course of conduct. For example, an agent may use his or her principal's property to usurp a business opportunity of the principal, and then utilize that opportunity to compete with the principal.

Corporate directors' and officers' fiduciary duties in this context generally track agency law precisely. Thus, use of corporate property for personal benefit is a breach of the duty of loyalty unless such use is authorized by a majority of the disinterested directors, the holders of a majority of the shares held by disinterested persons, or is otherwise fair and beneficial to the corporation. Similarly, a director or officer may not compete with his or her corporation during his or her affiliation unless the competition is authorized, after full disclosure, by disinterested directors or shareholders. However, severance of the relationship severs the former director's or officer's ongoing fiduciary duties. Therefore, absent a valid covenant not to compete, the former director or officer may freely compete with the corporation, but may not use confidential information derived from the former relationship.

At least from the standpoint of litigated cases, the most problematic of the three related duties is that concerning corporate opportunities. Part of the difficulty stems from failure to recognize that there are two separate issues involved. First, under what circumstances is a prospective business opportunity properly characterized as belonging, at least equitably, to the corporation? This question is crucial, because unless one can conclude that a business opportunity is a corporate opportunity there is no self-dealing conflict of interest. That is, unless the opportunity is at least equitably that of the corporation, the director or officer who takes it will not be receiving a benefit from the corporation that other, similarly situated shareholders are not receiving. Second, assuming an opportunity is a corporate opportunity, under what

176. Restatement (Third) of Agency §§ 8.02 & cmt. d, 8.04, 8.05(1) (Tentative Draft No. 6, 2005).
177. Id. § 8.05 cmt. b.
178. Principles of Corporate Governance, supra note 15, § 5.04. See also Schmidt v. Farm Credit Servs., 977 F.2d 511, 515 (10th Cir. 1992) (discussing use of corporate property pursuant to Kansas law); Branding Iron Motel, Inc. v. Sandlian Equity, Inc., 798 F.2d 396 (10th Cir. 1986) (same).
179. Principles of Corporate Governance, supra note 15, § 5.06.
180. Parsons Mobile Prods., Inc. v. Remmert, 216 Kan. 256, 260, 531 P.2d 428, 432 (1975); Restatement (Third) of Agency § 8.05 & cmt. c (Tentative Draft No. 6, 2005).
181. See Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971) (explaining that unless an opportunity is a corporate opportunity, there is no self-dealing).
circumstances is a director or officer justified in taking the opportunity for himself or herself?

As to the first issue, there are two widely recognized definitions or tests. The oldest and narrowest is known as the "interest or expectancy" test. It restricts corporate opportunities to those in which the corporation has an existing legal or equitable property interest or at least an expectancy growing from an existing right.\footnote{See Lagarde v. Anniston Lime & Stone Co., 28 So. 199, 201 (Ala. 1900) (distinguishing corporate opportunities from noncorporate opportunities).}

\textit{Guth v. Loft, Inc.}\footnote{5 A.2d 503 (Del. 1939).} casts a broader net. It is probably the best-known American corporate opportunity case, and it is widely cited for establishing the "line of business" test. Actually, \textit{Guth} enunciates two somewhat related and overlapping tests, the application of which depends on whether the opportunity came to the director or officer in his or her "individual" or "official" capacity, as follows:

It is true that when a business opportunity comes to a corporate officer or director in his individual capacity rather than in his official capacity, and the opportunity is one which, because of the nature of the enterprise, is not essential to his corporation, and is one in which it has no interest or expectancy, the officer or director is entitled to treat the opportunity as his own, and the corporation has no interest in it, if, of course, the officer or director has not wrongfully embarked the corporation's resources therein...\footnote{Id. at 510–11.}

On the other hand, it is equally true that, if there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself...\footnote{Id. at 514.}

Although the \textit{Guth} court included the interest or expectancy element under both facets of its corporate opportunity doctrine, it interpreted that element as being present if the corporation had an urgently pressing need for the opportunity even if there was no preexisting property interest or contractual expectancy.\footnote{Delaware has since watered the element down even more, in effect asking whether the opportunity was one in which the}
corporation was "interested" or constituted an activity in which it "expected" to engage.\textsuperscript{186}

The two leading Kansas cases have not had to come to grips with, or even recognize as a separate issue, the appropriate test for a corporate opportunity. The reason is that both, on the facts, involved opportunities in the same line of business as that of the corporation and in which the corporation had an existing interest or expectancy.\textsuperscript{187}

The second issue, after a business opportunity has been identified as a corporate opportunity, involves the circumstances under which a director or officer may take personal advantage of the opportunity without breaching the duty of loyalty. In Kansas, the test is the familiar one of good faith and intrinsic fairness, with the burden of proof on the director or officer.\textsuperscript{188}

As has been discussed, the law of directors' and officers' self-dealing contracts and transactions has evolved into a tripartite analysis in which "fairness" may be determined alternatively by a majority of the disinterested directors, the holders of a majority of the voting shares held by disinterested parties, or a disinterested judge.\textsuperscript{189} Unfortunately, in the factual context of corporate opportunities, a director or officer may simply appropriate the opportunity without first offering it to the


\textsuperscript{187} See generally Newton v. Homblewer, Inc., 224 Kan. 506, 582 P.2d 1136 (1978) (involving appropriation of opportunities to expand existing motel business); Parsons Mobile Prods., Inc. v. Remmet, 216 Kan. 256, 531 P.2d 428 (1975) (concerning two corporations manufacturing specialized vehicles). The American Law Institute has proposed a new, bifurcated definition of corporate opportunities that distinguishes between outside directors on one hand and inside directors and other officers on the other. The first part of the definition applies to all directors and officers and focuses on how the person becomes aware of the business opportunity. In general terms, if the director or officer learns of a business opportunity because of his or her connection with the corporation (i.e., in the person's official capacity or through the use of corporate information or property), then the opportunity is considered a corporate opportunity. Principles of Corporate Governance, supra note 15, § 5.05(b)(1). The second part of the definition applies only to inside directors and other officers and adopts an expanded, flexible line of business test. Id. § 5.05(b)(2). Limiting this broader definition to inside directors and other officers reflects a policy decision to encourage qualified persons to serve as outside directors as a matter of good corporate governance. In other words, section 5.05(b) attempts to strike a balance that protects the corporate interest while still allowing unaffiliated persons sufficient freedom in their other activities that they will not be deterred from becoming outside directors. Section 5.05 has proven to be quite popular with the courts of other jurisdictions. See, e.g., Ne. Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1150–52 (Me. 1995) (using section 5.05 in finding corporate opportunity); Demoulas v. Demoulas Super Mks., Inc., 677 N.E.2d 159, 180–82 (Mass. 1997) (same); Klimicki v. Lundgren, 695 P.2d 906 (Or. 1985) (same).

\textsuperscript{188} Newton, 224 Kan. at 519–20, 582 P.2d at 1146–47.

\textsuperscript{189} See supra Part V.A.1.
corporation. In such a case, there is no alternative forum outside the courtroom in which to test the fairness of the fiduciary’s conduct.

The American Law Institute has attempted to ameliorate this situation by requiring directors and officers invariably to offer all corporate opportunities to the corporation.\textsuperscript{190} If the corporation accepts the offer, that is the end of the matter. If the corporation rejects the offer, we can look at the corporate decision-makers who participated in the rejection. If the rejection was by a majority of the informed, disinterested directors, or the informed, disinterested shareholders, and the rejection was within the broad parameters of the business judgment rule, the director or officer is free to take the opportunity.\textsuperscript{191} If, however, the rejection was interested, the director or officer has the burden of proving that his or her appropriation was fair to the corporation.\textsuperscript{192} Because this articulation rationalizes the law governing corporate opportunities with that governing directors’ and officers’ self-dealing contracts and transactions, it has become popular in other jurisdictions and is worthy of serious consideration by the Kansas judiciary.\textsuperscript{193}

Finally, section 122(17) of the Delaware General Corporation Law provides as follows:

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\textsuperscript{190} Principles of Corporate Governance, \textit{supra} note 15, \S 5.05(a)(1). Note that the director or officer is not required to offer to the corporation \textit{all} business opportunities that come to him or her, only those that constitute \textit{corporate} opportunities. See \textit{id.} \S 5.05(b), discussed \textit{supra} note 187 (providing the definition of a corporate opportunity). Of course, whether a business opportunity constitutes a corporate opportunity may be difficult for the director or officer to determine \textit{ex ante}. Adding to the difficulty is the realization that the corporation may accept the offer, thus precluding any potential profit by the director or officer. Nevertheless, that is what duty demands, and all doubts should be resolved in favor of offering the opportunity to the corporation. \textit{Id.} Section 5.05(e), however, provides a safety valve in cases in which failure to offer stems from a good faith belief that the opportunity was not a corporate opportunity, by permitting a delayed offer not later than a reasonable time after suit is filed.

\textsuperscript{191} Id. \S 5.05(a)(2), (a)(3)(B)–(C), (c). Disinterested shareholder approval is even easier to obtain under the American Law Institute formulation than it is under Delaware law. All that is necessary is a majority of the shares \textit{actually voted} by disinterested parties, \textit{id.} \S 1.15, rather than a majority of the total number of shares \textit{held} by disinterested parties (whether or not present and voting). See \textit{supra} note 170 for a description of the Delaware rule.

\textsuperscript{192} Id. \S 5.05(a)(2), (a)(3)(A), (c).

\textsuperscript{193} See, e.g., Ne. Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1150 (Me. 1995) (adopting the American Law Institute standards regarding usurpation of corporate opportunity); Demoulas v. Demoulas Super Mkts., Inc., 677 N.E.2d 159, 180 (Mass. 1997) (discussing usurpation of corporate opportunity under the Principles of Corporate Governance); Klinicki v. Lundgren, 695 P.2d 906, 920 (Or. 1985) (adopting the Principles of Corporate Governance standards). Although Delaware has specifically declined to hold that corporate opportunities must always be offered to the corporation, it has stated that such an offer, followed by rejection, constitutes a “safe harbor” for the director or officer. Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 157–58 (Del. 1996).
Every corporation created under this chapter shall have power to: Renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors or stockholders. 194

Because this section refers to renunciation of business opportunities by a corporation’s board of directors, and does not require the director action to be disinterested, it could be read to alter radically the duty of loyalty with respect to corporate opportunities. This is neither the intent nor the effect of section 122(17). The section appears in Subchapter II of the Delaware General Corporation Law, 195 which contains seven sections that legislatively confer certain powers on corporate entities but do not purport to regulate the substantive use or operation of those powers. That section 122(17) is not intended to affect the duty of loyalty with respect to corporate opportunities is made abundantly clear by its legislative history, which provides as follows:

The subsection is intended to eliminate uncertainty regarding the power of a corporation to renounce corporate opportunities in advance .... It permits the corporation to determine in advance whether a specified business opportunity or class or category of business opportunities is a corporate opportunity of the corporation rather than to address such opportunities as they arise. The subsection does not change the level of judicial scrutiny that will apply to the renunciation of an interest or expectancy of the corporation in a business opportunity, which will be determined based on the common law of fiduciary duty, including the duty of loyalty. 196

That is, section 122(17) speaks only to the first of the two questions discussed above. It authorizes a corporation to define for itself in advance, either in its certificate of incorporation or by its board of directors, what business opportunities will be considered corporate opportunities. It does not speak at all to the second question: the duty of loyalty of a director or officer if a business opportunity constitutes a corporate opportunity.

B. Partnerships

As with the duty of care\textsuperscript{197} and the obligation of good faith and fair
dealing,\textsuperscript{198} current Kansas law exclusively and comprehensively codifies
partners’ duty of loyalty to the partnership and to each other, as follows:

A partner’s duty of loyalty to the partnership and the other partners is
limited to the following:
(1) To account to the partnership and hold as trustee for it any
property, profit, or benefit derived by the partner in the conduct
and winding up of the partnership business or derived from a use
by the partner of partnership property, including the appropriation
of a partnership opportunity;
(2) to refrain from dealing with the partnership in the conduct or
winding up of the partnership business as or on behalf of a party
having an interest adverse to the partnership; and
(3) to refrain from competing with the partnership in the conduct of
the partnership business before the dissolution of the partnership.\textsuperscript{199}

\textsuperscript{197} See supra Part III.B.
\textsuperscript{198} See supra Part IV.B.
\textsuperscript{199} KAN. STAT. ANN. § 56a-404(b) (2005). These duties apply equally to general partners of
limited partnerships. KAN. STAT. ANN. §§ 56-1a253(a), (c), -1a604 (2005); Welch v. Via Christi
seem to conflict with the duty of loyalty in subsection (b). Subsection (e) provides that “[a] partner
does not violate a duty or obligation under this act or under the partnership agreement merely
because the partner’s conduct furthers the partner’s own interest.” § 56a-404(e). This provision
simply recognizes and attempts to balance a partner’s rights as owner and principal with the
partner’s duties and obligations as fiduciary and agent. See REVISED UNIF. P’SHP ACT § 404 cmt. 5
(1997) (identifying the need to balance a partner’s rights as an owner against duties and obligations
as an agent or fiduciary). Nevertheless, the Kansas Supreme Court recently relied heavily and
repeatedly on subsection (e) to justify holding partners to a lesser standard of loyalty than that
applicable to corporate directors. Welch, 133 P.3d at 138-42. Subsection (f) provides that “[a]
partner may lend money to and transact other business with the partnership, and as to each loan or
transaction the rights and obligations of the partner are the same as those of a person who is not a
partner, subject to other applicable law.” § 56a-404(f). Although this provision may appear to be in
direct conflict with the prohibition against self-dealing transactions, it actually assumes compliance
with the duty of loyalty and obligation of good faith and fair dealing, and its focus is on the status of
a partner-creditor vis-à-vis outside creditors of the partnership. See REVISED UNIF. P’SHP ACT §
404 cmt. 6 (1997) (authorizing a partner to do business with the partnership and enjoy the rights of
a nonpartner). For further discussion, see Edwin W. Hecker, Jr., The Kansas Revised Uniform
Partnership Act, J. KAN. B. ASS’N 16, 32–33 (Oct. 1999). Finally, note that section 56a-404(a) and
the introductory language of section 56a-404(b) are phrased in terms of fiduciary duties “to the
partnership and the other partners.” § 56a-404(a), (b). The operative provisions in subsections
(b)(1), (2), and (3), however, focus solely on loyalty to the partnership as an entity, and completely
ignore situations implicating the duty of loyalty on a partner-to-partner basis. § 56a-404(b)(1)-(3).
As a result, the Kansas Supreme Court recently held that the general partner of a limited partnership
did not breach its duty of loyalty under section 56a-404(b) when it unilaterally orchestrated a cash-
out merger that froze out half of the limited partners at an allegedly inadequate price, but did not
This statement of the duty of loyalty clearly tracks corporate law and, in that respect, is consistent with prestatutory case law in Kansas.\footnote{200} Although stated as absolutes, these rules should be construed to permit validation of conduct that technically violates their strict prohibitions if the partner carries the burden of proving good faith and the fairness of the challenged conduct.\footnote{201} Moreover, as developed above, \footnote{202} “fairness” may consist of extrajudicial scrutiny and approval by informed, disinterested parties of conduct that otherwise would violate the duty of loyalty. This concept also is codified by the Kansas Revised Uniform Partnership Act, which provides that “all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.”\footnote{203} Under the statutory default requirement of unanimity, such authorization or ratification necessarily would include a majority (all) of the disinterested partners. If the partnership agreement provides for approval by a lesser number or percentage, care should be taken to make such a requirement explicit.

In addition, although a partnership agreement may not completely eliminate the duty of loyalty, it may identify in advance specific types or categories of activities that do not violate the duty, provided the identification is not manifestly unreasonable.\footnote{204} For example, an exculpatory provision in a real estate partnership agreement that authorizes the partnership to employ one of the partners who is a real estate agent and further authorizes the partner to retain standard commissions on partnership transactions undertaken by the partner should be permissible as not manifestly unreasonable.\footnote{205}


\footnote{201} See id. at 518, 582 P.2d at 1146 (noting that the party seeking to sustain the transaction must make “an affirmative showing of fairness and good faith” by “clear and satisfactory evidence”).

\footnote{202} See supra Part V.A.1.


\footnote{204} § 56a-103(b)(3)(i).

\footnote{205} Revised Uniform Partnership Act § 103 cmt. 4 (1997).
C. Limited Liability Companies

Unlike the Kansas Revised Uniform Partnership Act, the Kansas Revised Limited Liability Company Act does not purport to codify the duty of loyalty of members and managers of a limited liability company. Nevertheless, recent case law specifically recognizes the propriety of reference to the partnership statute when instructing the jury on the fiduciary duty of members of a Kansas limited liability company.

Furthermore, there is ample Delaware precedent applying corporate directors’ loyalty concepts to managers of limited liability companies. For example, Delaware now routinely applies the entire fairness standard that governs self-dealing corporate mergers to analogous situations involving limited liability companies. In addition, a recent decision supports the proposition that approval of self-dealing by an informed majority of the disinterested managers obviates the necessity of a fairness inquiry and insulates the transaction under the business judgment rule.

As has previously been mentioned, the Kansas Revised Limited Liability Company Act states that its policy is to give maximum effect to freedom of contract and to the enforceability of operating agreements. More specifically, it provides that to the extent a member, manager, or other person has duties and liabilities, including fiduciary duties, to the limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by the operating agreement. Moreover, any such member, manager, or other person acting under an operating agreement will not be liable for good faith reliance on the operating agreement. These provisions obviously emphasize the contractual nature of limited liability companies and are especially relevant to the nature and scope of fiduciary duties. Several

206. UNIF. LTD. LIAB. CO. ACT § 409(b), (h) (1996), which is not in force in Kansas, codifies members’ and managers’ duties of loyalty in a manner that is identical to partnership law.
210. See supra text accompanying notes 106–08.
211. KAN. STAT. ANN. § 17-76,134(b) (Supp. 2005).
212. § 17-76,134(c)(2).
213. § 17-76,134(c)(1).
recent judicial opinions concerning the effect of operating agreements on fiduciary duties provide useful insight.

In *Lynch Multimedia Corp. v. Carson Communications, L.L.C.*, an operating agreement provided that opportunities in the limited liability company's line of business that came to a member from certain designated sources or that existed in specified geographical areas must first be offered to the company and rejected before being pursued individually by the member.\(^{214}\) It also stated that members and managers could engage in other businesses of any nature without being deemed to have violated any duty to the limited liability company or to the other members.\(^{215}\) The court held that these provisions were authorized by the statute and that the contractual duties supplanted any more generalized common law duties relating to business opportunities or competition.\(^{216}\)

The operating agreement in *Flight Options International, Inc. v. Flight Options, LLC* provided generally that the fiduciary duties of members and managers would be the same as those of shareholders and directors of a Delaware corporation.\(^{217}\) The agreement further specifically provided that, unless otherwise approved by a majority of the disinterested managers, transactions between the limited liability company and an affiliate "will be on arms’ length terms and conditions, including fair market values and prices equivalent to those that would be charged and paid between parties at arms’ length."\(^{218}\) In a highly questionable reading of the operating agreement, the court interpreted the "arms’ length" language to be a relaxation rather than an explication of the entire fairness standard, and applied it to an admitted self-dealing transaction between the limited liability company and its controlling member.\(^{219}\)

In *Solar Cells, Inc. v. True North Partners, LLC*,\(^{220}\) the operating agreement also recognized the potential for conflicts of interest between the controlling member and managers appointed by it and the limited liability company and its other member. In the event of such a conflict, the agreement provided that neither the managers nor the controlling member would have any liability as long as the managers acted in the good faith belief that their decision was in the best interest of the

\(^{215}\) Id. at 1262–63.
\(^{216}\) Id. at 1265.
\(^{218}\) Id.
\(^{219}\) Id. *7–8 & n.34.
company. In a suit by the other member to enjoin an allegedly unfair self-dealing merger, the court held the provision in the operating agreement to be inapplicable because it only purported to limit liability rather than to waive the duty of loyalty.

The Solar Cells case does, however, raise the question whether the statutory language that permits fiduciary and other duties to be “expanded or restricted” by the operating agreement is sufficiently broad to authorize a complete waiver of the duty of loyalty and other fiduciary duties. In Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., which involved identical language in Delaware’s limited partnership statute, the Delaware Supreme Court expressed doubt whether total abolition of fiduciary duties was authorized. It noted that the language of the statute did not expressly refer to “elimination” of fiduciary duties. In addition, the court observed that the historic approach of Delaware courts has been to scrutinize searchingly the efforts of fiduciaries to escape fiduciary duties. The Delaware legislature responded to the dictum in Gotham Partners by amending its partnership act, limited partnership act, and limited liability company act expressly to permit expansion, restriction, or elimination of fiduciary and other duties and liability for the breach thereof. However, no agreement may eliminate the implied contractual covenant of good faith and fair dealing or limit or eliminate liability for a bad faith breach of the implied covenant.

This is one respect in which Kansas should not follow Delaware’s lead. Unbridled “freedom of contract” is little more than the law of the jungle and is bad policy because it fails to account for unequal knowledge, experience, sophistication, and bargaining power. It also would drive an illogical wedge between Kansas corporations and their unincorporated counterparts.

221. Id. at *4.
222. Id.
224. 817 A.2d 160 (Del. 2002).
225. Id. at 167–68.
229. See supra Parts IV.B. & C.
VI. CONCLUSION

At the outset, this Article stated its goal as an attempt to survey generally the law of fiduciary and related duties as applied to Kansas corporations, partnerships, and limited liability companies, and to illustrate the extent to which corporate analysis and precedents have permeated the other forms of business organization. Certainly, this is strikingly true of partnership fiduciary duties, which now legislatively track corporate duties of care and loyalty with precision.\textsuperscript{230} The law governing fiduciary duties in the context of limited liability companies is still largely in the developmental stage, but it borrows concepts from partnerships and more heavily from corporations. The legal regimes applicable to all three are subject to some degree of individual change by governing document, with limited liability companies permitting the greatest amount of liberality and corporations the least.

While this Article does not purport to be completely comprehensive or exhaustive, one hopes that it is sufficiently thorough to serve as a starting point for further investigation of a trend of parallelism that promises to extend well into the future.

\textsuperscript{230} But see Welch v. Via Christi Health Partners, Inc., 133 P.3d 122 (Kan. 2006) (holding partners to a less rigorous duty of loyalty than that applicable to corporate directors and confining that duty to the partnership entity, to the exclusion of the other partners).